Essay
A Requiem: Reflections on *Gustafson*

THERESE MAYNARD*

As we mark the first anniversary of the decision in *Gustafson v. Alloyd Co.*,[1] it seems appropriate to reflect on the impact of the Supreme Court's wayward opinion in that case. During the past year, securities lawyers have struggled to absorb the implications of the Court's reasoning in *Gustafson.* As the bench and bar grapple to understand the Court's method of analysis in that case, it has become increasingly clear that one of the most profound—although perhaps unintended—consequences of the Court's opinion in *Gustafson* is the impact it has had on the practice of securities law.

This Essay is an effort to focus attention on the troubling results for the legal profession from the Court's methodology in *Gustafson.* This Essay will

---

* Professor of Law, Loyola Law School. I thank Kay Tate, Maggie Sachs, Norm Poser, and Jim Gordon for their extremely insightful comments on an earlier draft of this Essay, and Anastasia Liakas for her invaluable research assistance.

[1] 115 S. Ct. 1061 (1995). The Court's decision was rendered on February 28, 1995. At the time the Supreme Court granted certiorari in the *Gustafson* case, the Third and Seventh Circuits were in conflict. "As the first appellate court to squarely address the issue of the scope of section 12(2), the Third Circuit had held that [section 12(2)] relief is limited to *only* those buyers who are defrauded during the course of initial distribution transactions." Therese H. Maynard, *Implications of* Central Bank *on* Gustafson, N.Y. L.J., July 7, 1994, at 5 (emphasis added) (describing holding in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991)). Subsequently, the Eleventh Circuit adopted the rule of *Ballay*. First Union Discount Brokerage Servs. v. Milos, 997 F.2d 835 (11th Cir. 1993). The Seventh Circuit, on the other hand, "concluded that the express remedy of section 12(2) is available to *any* buyer who satisfies the statute's prerequisites—regardless of whether the plaintiff's purchase was made during the course of a distribution or a trading market transaction." Maynard, *supra* (emphasis added) (describing the holding in *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993)). The haste with which this issue reached the High Court for resolution has led at least one commentator to observe:

> [The Supreme Court's decision in *Gustafson* is] a testimonial to the Supreme Court's former practice of showing restraint in deciding cases where lower court decisions are insufficiently ripe. . . . [Otherwise,] the Court . . . injects itself headlong into an unfamiliar realm and seeks to make new law without fully displaying an understanding of the ramifications of its decision.

Ted J. Fiflis, Gustafson v. Alloyd Co., Inc.: *Judicial vs. Legislative Power*, 23 SEC. REG. L.J. 423, 440–41 (1996).

describe how the Court's decision further contributes to the disintegration of the common understanding of established precedent which had interpreted that body of statutes known as the federal securities laws.[2] This disintegration carries important consequences for the practice of corporate securities law that has received scant public comment. By focusing attention on these implications, this Essay will serve to underscore the urgent need for the legal profession to acknowledge its obligations as responsible problem solvers in securities law matters.[3]

---

[2] As we bear witness to the erosion of a settled body of administrative and judicial precedent interpreting the federal securities laws, one of the most profound implications of the Court's decision becomes increasingly clear: The Court's methodology in *Gustafson* has given lawyers a license to challenge established precedent. *See infra* notes 75-78 and accompanying text (describing implications of *Gustafson*'s reasoning for the private placement market as one example of the decision's impact on established precedent); Therese H. Maynard, *The Impact of* Gustafson *and Its Methodology*, 24 SEC. REG. L.J. 61 (1996). In so doing, lawyers have been released from assuming the burden of responsible counseling when applying provisions of the federal securities laws. Ironically, this new found "hunting license" is conferred on the bar at a time when public and Congressional foment over the excesses of securities litigation has led to the enactment of significant legislation reforming litigation under the federal securities laws. *See infra* note 4 (discussing passage of the Private Securities Litigation Reform Act of 1995). Oddly enough, though, as the bench and bar struggle to understand *Gustafson*, one of the consequences least commented on—perhaps least noticed—is the deleterious impact this decision has visited on the counseling function of the securities lawyer. *See infra* notes 79-80 and accompanying text (describing impact of *Gustafson* on securities lawyers).

[3] The criticisms set forth in this Essay of *Gustafson*'s methodology may very well be leveled at other substantive areas of Supreme Court decisionmaking. This Essay, however, is deliberately focused on the Court's jurisprudence under the federal securities laws for two important reasons. First, on the basis of my own experience as well as discussions with other securities lawyers over the past year, I am confident that my observations with respect to the impact of *Gustafson* on the practice of securities law are well founded. Second, and more importantly, federal securities law is a distinct body of jurisprudence born out of a discrete body of statutes. As such, this discrete body of federal law exists to regulate our nation's capital markets, an important national asset. *See* Securities Exchange Act § 2, 15 U.S.C. § 78b (1994). For many, the unique role played by the federal securities laws in fostering and protecting this important national asset may be enough to support singling out for special scrutiny the method of analysis used by the Court in this area of the law. In any case, to the extent that the observations raised in this Essay are appropriate to other substantive areas of Supreme Court jurisprudence (bankruptcy and tax law, for example, come readily to mind), I suggest that students of these other disciplines mount a similar challenge to the Court's inconsistent methods of analysis, especially if those inconsistent methods are having the same deleterious impact on the ability of lawyers in these areas to act as responsible problem solvers. For the reasons just given, however, this Essay will

I. BACKGROUND OF SUPREME COURT'S FEDERAL SECURITIES LAW DECISIONS

Most significant for purposes of this Essay is the unexpected method of analysis that the Supreme Court used in *Gustafson* to support its narrow interpretation of section 12(2) of the Securities Act of 1933 (1933 Act).[4] In the end, it is the methodology, and *not* the result reached in *Gustafson*, that yields distressing consequences. The methodology used by the Court to reach its decision in *Gustafson* represents a dramatic shift in the Court's approach to interpreting the federal securities laws. Accordingly, some background regarding the Supreme Court's interpretation of the fraud remedies available under the federal securities laws is crucial to understanding the implications of the Court's methodology in *Gustafson*.

Prior to the mid-1970s, the express remedy of section 12(2) lived in the shadow of the much more popular implied private remedy of Rule 10b-5.[5] By its terms, Rule 10b-5 gives the SEC the authority to bring actions for securities fraud. Beginning in the 1940s, however, the federal courts implied a private remedy under Rule 10b-5.[6] As an implied remedy, it is the responsibility of the federal courts—and ultimately, the Supreme Court—to define the scope of relief available under Rule 10b-5.[7]

---

focus on the Court's method of analysis under the federal securities laws.

[4] 15 U.S.C. § 77*l*(a)(2) (Supp. 1996). In December 1995, Congress passed the Private Securities Litigation Reform Act of 1995. Pub. L. No. 104-67, 109 Stat. 737 (1995); *See* Senate Overrides President's Veto; Securities Litigation Reform Bill Now Law, 28 Sec. Reg. & L. Rep. (BNA) 2 (Jan. 5, 1996). As part of this legislation, Congress added a new subsection to section 12, and therefore section 12(2) has now been renumbered section 12(a)(2). Pub. L. No. 104-67, 109 Stat. 737, 757 (1995). This legislative change, however, does not alter the original language of section 12(2) itself nor otherwise impact the substantive analysis of this Essay. For the reader's ease of reference, this Essay will continue to refer to the section 12 fraud remedy as "section 12(2)."

[5] 17 C.F.R. § 240.10b-5 (1995).

[6] *See* Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). In 1971, the Supreme Court confirmed the existence of an *implied* private right of action under Rule 10b-5. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13n.9 (1971).

[7] For general discussions of Rule 10b-5 and its implied remedy, see 3-3C HAROLD S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW (1986); 1-6 ALAN R. BROMBERG & LEWIS D. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD *passim* (1990 ed.); 1-3 ARNOLD S. JACOBS, THE IMPACT OF RULE 10B-5 (1980 rev.); RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 784–1349 (7th ed. 1992); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 777-875 (3d ed. 1995). In addition to the articles cited in these authoritative treatises, see also Douglas M. Branson, *Prescience*

Early on, the Supreme Court's decisions were characterized by an expansive approach to interpreting the various provisions of the federal securities laws.[8] In these early years, on the very few occasions that the Supreme Court was called upon to interpret the Rule 10b-5 remedy itself, the Court painted with a very broad brush.[9] Owing in large part to the hospitable climate created by this expansive attitude towards Rule 10b-5, the implied remedy flourished in the lower courts. With time, Rule 10b-5 became the defrauded plaintiffs' favored remedy. Indeed, it was the most widely used remedy under the federal securities laws.[10] In fact, Rule 10b-5 ballooned so much that it eclipsed the express remedies Congress established under the federal securities laws, including the express remedy of section 12(2).

By the mid-1970s, however, a dramatic shift occurred in the Court's attitude. The Court took a definite dislike to implied remedies in general and its

---

and Vindication: Federal Courts, SEC Rule 10b-5, and the Work of David S. Ruber, 85 NW. U. L. REV. 613 (1991); Steven Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990).

[8] *See, e.g.*, J.I. Case Co. v. Borak, 377 U.S. 426 (1964). On the question of the implication of a private right of action, see generally 1 BROMBERG & LOWENFELS, *supra* note 7, ch. 2; JENNINGS ET AL., *supra* note 7, ch. 13; Alfred F. Conard, *Securities Regulation in the Burger Court*, 56 U. COLO. L. REV. 193 (1985); Michael J. Kaufman, *The Uniform Rule of Liability Under the Federal Securities Laws: The Judicial Creation of a Comprehensive Scheme of Investor Insurance*, 63 TEMPLE L. REV. 61 (1990); Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985); William F. Schneider, *Implying Private Rights and Remedies Under the Federal Securities Acts*, 62 N.C. L. REV. 853 (1984); Marc I. Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 CORNELL L. REV. 557 (1982).

[9] *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). Justice Douglas's opinion in that case has been characterized as reflecting the "apogee of the reach of Rule 10b-5. The facts illustrate the breadth in the potential wrongdoing covered [by the Rule 10b-5 remedy]." CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 848 (1992); *see also* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (adopting an expansive interpretation of the reliance requirement of Rule 10b-5 in a manner that is generally regarded as favorable to plaintiffs).

[10] *See* LOSS & SELIGMAN, *supra* note 7, at 779. The story of the rise and fall of Rule 10b-5's implied remedy has been chronicled at length in the literature. *See generally* BROMBERG & LOWENFELS, *supra* note 7; 5-5e ARNOLD S. JACOBS, LITIGATION & PRACTICE UNDER RULE 10b-5 (2d ed. 1981); DONALD C. LANGEVOORT, INSIDER TRADING REGULATION: A TREATISE ON THE DEFINITION, PREVENTION AND REGULATION OF INSIDER TRADING (1990 ed.); LOSS & SELIGMAN, *supra* note 7, at 777–80; Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961 (1994).

dislike for the implied remedy of Rule 10b-5 became most apparent.[11] In a series of decisions rendered in the mid-to-late 1970s, the Court substantially curtailed the availability of relief under Rule 10b-5 by adopting a more restrictive interpretation of the elements of this implied cause of action.[12] As a result, the Court's decisions now make it much harder for plaintiffs to recover under Rule 10b-5.[13]

What is most important for purposes of this Essay is the *method* used by the Court to do all this pruning. The Court repeatedly emphasized that the *scope* of the Rule 10b-5 remedy was defined by the *express* language of the *statute*. Therefore, efforts by the SEC or private litigants to present policy arguments urging the Court to take a more expansive approach to interpreting the scope of Rule 10b-5 were eschewed in favor of keeping the focus on the language of the statute—that is, the language of section 10(b) of the Securities Exchange Act of 1934.[14] The Court grew fond of beginning its opinions in this area with the mantra: The starting point of our analysis is, as it must be, the language of the statute.[15]

Moreover, this *same* analytical approach was used by the Court on the very few occasions when an issue under the federal securities laws other than Rule 10b-5 presented itself to the Court. For example, in 1985 in *Landreth Timber v. Landreth*,[16] the Court had to resolve the fate of what had become known as the "sale of business" doctrine.[17] Specifically, the Supreme Court

---

[11] "During the 1960s and early 1970s, federal courts extended Rule 10b-5 to cover a broad range of corporate activity .... After several new appointments to the Supreme Court in the 1970s, the Court began limiting sharply the reach of the rule." O'KELLEY & THOMPSON, *supra* note 9, at 841.

[12] *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). The High Court's continuing hostility towards the implied cause of action under Rule 10b-5 is reflected in more recent Court decisions as well. *See, e.g.*, Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991); Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439 (1994).

[13] Not surprisingly, as recovery under Rule 10b-5 became more difficult, reliance on the express remedy of section 12(2) increased. *See* Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 WM. & MARY L. REV. 847, 851 (1991).

[14] 15 U.S.C. § 78j(b) (1994).

[15] *See, e.g.*, Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985); Teamsters v. Daniel, 439 U.S. 551, 558 (1979); *Ernst & Ernst*, 425 U.S. at 197; *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring).

[16] 471 U.S. 681 (1985).

[17] Until *Landreth*, the sale of business doctrine was relied on by several lower federal

had to decide if the transaction at issue in that case involved the sale of a "security."[18] To decide this issue, the Court—not surprisingly—turned to the language of the statute as the starting point of its analysis. In particular, the Court looked first to the language of section 2 of the 1933 Act, which defines the terms used throughout the remaining provisions of the 1933 Act.[19] Thus,

---

courts to conclude that "a sale of an entire business [was] not considered a 'security' transaction for the purposes of the [federal] securities laws, even if [the transaction] was accomplished by a sale of stock having the traditional attributes of stock ownership." JENNINGS ET AL., *supra* note 7, at 299. The commentators, like the lower federal courts, were sharply divided as to whether the sale of all or part of the stock of a business organized as a corporation qualified as a "security" under the federal securities laws. *See, e.g.*, Stephen J. Easley, *Recent Developments in the Sale-of-Business Doctrine: Toward a Transactional Context-Based Analysis for Federal Securities Jurisdiction*, 39 BUS. LAW. 929 (1984); Scott FitzGibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980); Thomas L. Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When Is Stock Not a Security?*, 61 N.C. L. REV. 393 (1983); Dennis S. Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. REV. 413 (1992); Gary S. Rosin, *Functional Exclusions from the Definitions of a Security*, 28 S. TEX. L. REV. 333, 575 (1986); Gary S. Rosin, *Historical Perspectives on the Definition of a Security*, 28 S. TEX. L. REV. 575 (1987); Irving P. Seldin, *When Stock Is Not a Security: The "Sale of Business" Doctrine Under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982); Robert B. Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225 (1982); Christine L. McAneny, Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. U. L. REV. 295 (1980); Jacque L. Nims, Comment, *A Criticism of the Sale of Business Doctrine*, 71 CAL. L. REV. 974 (1983); Note, *Repudiating the Sale-of-Business Doctrine*, 83 COLUM. L. REV. 1718 (1983). Similarly, the federal courts were divided in their willingness to accept the sale of business doctrine. Some appellate courts *rejected* the sale of business doctrine. *See, e.g.*, Ruefenacht v. O'Halloran, 737 F.2d 320, 338 (3d Cir. 1984), *aff'd sub nom.* Gould v. Ruefenacht, 471 U.S. 701 (1985); Daily v. Morgan, 701 F.2d 496, 497 (5th Cir. 1983); Cole v. PPG Indus., Inc., 680 F.2d 549, 556 (8th Cir. 1982); Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982); Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir. 1979). Other appellate courts *accepted* the sale of business doctrine. *See, e.g.*, Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1353 (9th Cir. 1984), *rev'd*, 471 U.S. 681 (1985); Christy v. Cambron, 710 F.2d 669, 672 (10th Cir. 1983); King v. Winkler, 673 F.2d 342, 346 (11th Cir. 1982); Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982).

[18] *See Landreth*, 471 U.S. at 683. This case is important not only because of the method the Court used to decide the narrow issue before it, but also because the facts of *Landreth* are substantially the same as the facts of *Gustafson*. *See infra* notes 42–44 and accompanying discussion (describing transaction at issue in *Gustafson*).

[19] 15 U.S.C. § 77b (1994).

the starting point of the Court's analysis was the definition of "security" contained in section 2(1).[20] In so doing, the Court ignored the substantial body of commentary that urged it to reject a straightforward application of the plain meaning of the statute.[21] The Supreme Court indicated that it felt constrained to give force and effect to the definitions set out in the statute, and that these definitions formed the foundation for the Court's analysis.[22]

Again in 1988, the Court was required to consider the scope of section 12(1), which contains the other express remedy set out by Congress in section 12 of the 1933 Act.[23] In *Pinter v. Dahl*,[24] the plaintiff brought a cause of action under section 12(1) against the seller-defendant for rescission of the plaintiff's purchase of a security. The High Court was required to decide if the defendant fell within the scope of "seller," as that term was used in section 12(1). To decide this issue, the Court again turned to the definitions in section 2 and—not surprisingly—focused its analysis on the definition of the terms "offer" and "sale" contained in section 2(3).[25] This approach is entirely consistent with the methodology developed by the Supreme Court over the last twenty years in its securities law decisions.

II. Background Regarding the Elements of Section 12(2) Cause of Action

A. *The Elements of a Section 12(2) Action*

Before examining the method of analysis used by the Court to decide *Gustafson*, a brief overview of the elements of a section 12(2) cause of action is

---

[20] *See* 15 U.S.C. § 77b(1) (1994). In focusing on the language of the statute, the Court characterized its responsibility in this area as involving an effort to give force and effect to the specific language of Congress' definition of the term "security."

[21] *See supra* note 17.

[22] *See Landreth*, 471 U.S. at 685-88. Echoing many of the arguments put forward by the proponents of the sale of business doctrine, Justice Stevens dissented in *Landreth*. *See id.* at 697-700 (Stevens, J., dissenting).

[23] 15 U.S.C. § 77*l*(a)(1) (Supp. 1996). The Private Securities Litigation Reform Act, enacted in December 1995, added a new subsection to section 12 of the 1933 Act, resulting in the renumbering of the section 12(1) remedy as section 12(a)(1). Pub. L. No. 104-67, 109 Stat. 737, 757 (1995); *see supra* note 4. For the reader's convenience of reference, this Essay will refer to the rescission remedy now provided in section 12(a)(1) as "section 12(1)."

[24] 486 U.S. 622 (1988).

[25] *See id.* at 643-47.

in order. First, though, a word of caution: The following description of the section 12(2) remedy is based on established precedent interpreting the language of the 1933 Act in accordance with the analytical framework created by the Court's pre-*Gustafson* securities law decisions. However, as several commentators have pointed out,[26] much of this settled understanding has now been called into question by the Court's reasoning in *Gustafson*.

Section 12(2) allows the purchaser to obtain rescission from her immediate seller.[27] In other words, the statute allows the buyer to recover her purchase price from the person (or persons) who constitute the seller (or sellers) of the securities to that buyer. This relationship is generally referred to as the *privity* requirement of section 12.[28] In *Pinter v. Dahl*,[29] the Supreme Court gave a

---

[26] For recent commentary discussing the *Gustafson* decision, see Stephen M. Bainbridge, *Securities Act Section 12(2) After the* Gustafson *Debacle*, 50 BUS. LAW. 1231 (1995); Harold Bloomenthal, *Supreme Court Says That Section 12(2) Liability Does Not Extend to Private Offerings or Secondary Trading*, 12 SEC. & FED. CORP. L. REP. 25 (CBC) (April 1995); Fiflis, *supra* note 1; Maynard, *supra* note 2; Gerald A. Novack & Audrey B. Venezia, Gustafson v. Alloyd Co.*: Limiting Section 12(2) Liability to Public Offerings*, 28 REV. SEC. & COMMODITIES REG. 189 (Nov. 8, 1995); Ann D. Wallace & Mary J. Kosterlitz, *Securities Act Liability*, *in* NUTS AND BOLTS OF SECURITIES LAW, at 175 (PLI Corp. L. & Prac. Course Handbook Series No. 889, 1995); Elliott J. Weiss, *Securities Act Section 12(2) After* Gustafson v. Alloyd Co.*: What Questions Remain?*, 50 BUS. LAW. 1209 (1995); Bruce Angiolillo, Gustafson*: Section 12(2) Applies Only to IPO's*, N.Y. L.J., Mar. 7, 1995, at 1; Dennis J. Block & Jonathan M. Hoff, *Scope of Section 12(2) After* Gustafson, N.Y. L.J., July 6, 1995, at 5; Richard A. Booth, *The Scope of Section 12(2) After* Gustafson, 9 INSIGHTS 8 (July 1995); Christine Evans, *Court Case May Reduce Intermediary Liability on Private Placements*, CORP. FINANCING WK., June 19, 1995, at 1; Roberta S. Karmel, *Curtailing Civil Liability*, N.Y. L.J., Apr. 20, 1995, at 3.

[27] In terms of relief, section 12(2) is generally understood to allow the plaintiff to rescind and get back all of the consideration he paid, if he still owns the security. . . . [Alternatively, if] the plaintiff no longer owns the security, he may recover his "damages." . . . The statute makes no attempt to define what these are; . . . the damages recoverable under section 12 would, however, presumably be a "rescissionary" measure of damages since [section 12(2)] basically grants only a right of rescission.

JENNINGS ET AL., *supra* note 7, at 1340.

[28] *See generally* THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 281–87, 318–25 (2d ed. 1990); Patricia A. O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 UCLA L. REV. 921 (1984); Bryan M. Schneider, *Section 12 of the Securities Act of 1933: The Privity Requirement in the Contemporary Securities Law Perspective*, 51 TENN. L. REV. 235 (1984).

fairly narrow definition to the term "seller" as used in section 12(1).[30] Since *Pinter*, the lower courts have consistently relied on *Pinter* to determine the scope of "seller" for purposes of a section 12(2) cause of action as well.[31] In

---

[29] 486 U.S. 622 (1988).

[30] *See id.* at 647. The Supreme Court decided the scope of seller in *Pinter* basing its analysis in substantial measure on the definitions of "offer" and "sale" found in section 2(3) of the statute. *See id.* at 643. In so doing, the Supreme Court rejected the substantial factor test, which offered a more expansive interpretation of the term "seller" that had been adopted by several of the lower federal courts. *See id.* at 648–54.

[31] In *Pinter v. Dahl*, the Court addressed the question of who is a seller for purposes of section 12(1) only. *Id.* at 625. However, "lower federal courts have overwhelmingly applied the [*Pinter*] holding to cases arising under § 12(2)." MARC STEINBERG, SECURITIES REGULATION 595 (2d ed. 1993); *see* Cortec Indus., Inc. v. SUM Holding L.P., 949 F.2d 42, 49 (2d Cir. 1991); Ackerman v. Schwartz, 947 F.2d 841, 844 (7th Cir. 1991); Ryder Int'l Corp. v. First Am. Nat'l Bank, 943 F.2d 1521, 1530 (11th Cir. 1991); *In re* Craftmatic Sec. Litig., 890 F.2d 628, 635 (3d Cir. 1989); Royal Am. Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011, 1016–17 (2d Cir. 1989); Moore v. Kayport Package Express, Inc., 885 F.2d 531, 536 (9th Cir. 1989); Crawford v. Glenns, Inc., 876 F.2d 507, 510 (5th Cir. 1989); Wilson v. Saintine Exploration & Drilling Corp., 872 F.2d 1124, 1126 (2d Cir. 1989); Schlifke v. Seafirst Corp., 866 F.2d 935, 940–42 (7th Cir. 1989) (holding that defendant was not seller under section 12(2) under substantial factor test or under *Pinter* but not deciding whether or not *Pinter* applies to section 12(2) claims); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1113-15 (5th Cir. 1988), *vacated sub nom.* Fryar v. Abell, 492 U.S. 914 (1989); Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988); Pompano-Windy City Partners Ltd. v. Bear Stearns & Co., 794 F. Supp. 1265, 1284 (S.D.N.Y. 1992); Davis v. Coopers & Lybrand, 787 F. Supp. 787, 799-802 (N.D. Ill. 1992); Scholes v. Stone, McGuire & Benjamin, 786 F. Supp. 1385, 1399 (N.D. Ill. 1992); *In re* Sahlen & Assoc., Inc. Sec. Litig., 773 F. Supp. 342, 364 (S.D. Fla. 1991); *In re* Newbridge Networks Sec. Litig., 767 F. Supp. 275, 280–81 (D.D.C. 1991); Mabon, Nugent & Co. v. Borey, 127 B.R. 727, 733-34 (S.D.N.Y. 1991); Morin v. Trupin, 747 F. Supp. 1051, 1063 (S.D.N.Y. 1990); Wiley v. Hughes Capital Corp., 746 F. Supp. 1264, 1280 (D.N.J. 1990); Dalton v. Alston & Bird, 741 F. Supp. 1322, 1331 (S.D. Ill. 1990); Craig v. First Am. Capital Resources, 740 F. Supp. 530, 534 (N.D. Ill. 1990); Dawe v. Main Street Management Co., 738 F. Supp. 36, 38 (D. Mass. 1990); VT Investors v. R & D Funding Corp., 733 F. Supp. 823, 839 (D.N.J. 1990); Epstein v. Haas Sec. Corp., 731 F. Supp. 1166, 1185 (S.D.N.Y. 1990); Sellin v. Rx Plus, Inc., 730 F. Supp. 1289, 1292 (S.D.N.Y. 1990); Buford White Lumber Co. v. Octagon Properties, Ltd., 740 F. Supp. 1553, 1558 (W.D. Okla. 1989); Levine v. Diamanthuset, Inc., 722 F. Supp. 579, 585–86 (N.D. Cal. 1989), *rev'd*, 950 F.2d 1478 (9th Cir. 1991); *In re* Worlds of Wonder Sec. Litig., 721 F. Supp. 1140, 1147–48 (N.D. Cal. 1989); Mix v. E.F. Hutton & Co., 720 F. Supp. 8, 9 (D.D.C. 1989); Mercer v. Jaffe, Snider, Raitt & Heuer, P.C., 713 F. Supp. 1019, 1024 (W.D. Mich. 1989), *aff'd*, 933 F.2d 1008 (6th Cir 1991); Jackson v. First Fed. Sav. of Ark., 709 F. Supp. 863, 883 (E.D. Ark. 1988); Scotch v. Moseley, Hallgarten, Estabrook & Weeden, Inc., 709 F. Supp. 95, 97 (M.D. Pa. 1988); Marshall v. Quinn-L Equities,

these decisions, the lower courts relied on the *Pinter* formulation of the term "seller" primarily on the grounds that they could see no principled way—given the language of the statute and the tenor of the Supreme Court's decisions interpreting the federal securities laws—to reach any other result.

To recover under section 12(2), the buyer must also show that the seller made a misleading statement "by prospectus or oral communication."[32] The definition of the term "prospectus" had long been interpreted by reference to the definition of this term found in section 2(10) of the 1933 Act.[33] The statute's definition of prospectus is quite inclusive and a great deal of authority had developed since the statute's enactment supporting a broad interpretation of section 12(2)'s use of the term.[34] Finally, the buyer must show that the seller's misleading statement was *material*.[35] This element means that the buyer must show that the statement was one to which a reasonable investor would attach importance.[36]

Once these elements are established, the buyer is entitled to relief if the seller does not sustain a successful defense. Most importantly, though, section 12(2) carries with it what is known as the seller's reasonable care defense, which requires the defendant to prove "that he did not know, and in the exercise of reasonable care could not have known" of the untruth or omission.[37] The sparse case law describing the scope of this affirmative defense established that the statute meant what it said: The seller has the burden of

---

Inc., 704 F. Supp. 1384, 1387–90 (N.D. Tex. 1988); Flournoy v. Peyson, 701 F. Supp. 1370, 1379 (N.D. Ill. 1988); Laven v. Flanagan, 695 F. Supp. 800, 813 (D.N.J. 1988); *In re* Professional Fin. Management Ltd., 692 F. Supp. 1057 (D. Minn. 1988).

[32] 15 U.S.C. § 77*l*(a)(2) (Supp. 1996).

[33] *See* Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578, 587–88 (7th Cir. 1993); Fiflis, *supra* note 1.

[34] *See* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 460–65 (3d ed. 1989); Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 NOTRE DAME L. REV. 57, 77 (1993).

[35] *See* 15 U.S.C. § 77*l*(a)(2) (Supp. 1996).

[36] *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (expressly adopting *TSC Industries* materiality definition). Although the Supreme Court originally formulated this definition in the context of implied causes of action under Rule 14a-9 and Rule 10b-5 of the Securities Exchange Act of 1934, lower federal courts have generally followed this standard in interpreting the concept of materiality under other provisions of the federal securities laws. *See, e.g.*, Alton Box Bd. Co. v. Goldman, Sachs & Co., 560 F.2d 916, 919–20 (8th Cir. 1977) (applying the *TSC Industries* standard of materiality to a section 12(2) suit); LOSS & SELIGMAN, *supra* note 7, at 473.

[37] 15 U.S.C. § 77*l*(a)(2) (Supp. 1996).

demonstrating his, her, or its exercise of reasonable care.[38] This burden is essentially a fact-intensive inquiry.[39]

In sum, Congress left it to the seller to show that he is not culpable, rather than requiring the buyer to prove state of mind, or scienter, as part of the plaintiff's case-in-chief.[40] Most importantly, as reflected in the facts of *Gustafson*,[41] section 12(2) allows the seller to demonstrate the parties' agreed-upon allocation of the due diligence burden and the economic risks of the transaction.

B. *The Facts of* Gustafson v. Alloyd Co.

With that brief background, we turn now to the facts of *Gustafson*.[42] The transaction at issue in *Gustafson* involved substantially the same kind of transaction that was at issue in an earlier line of cases developing the sale of business doctrine.[43] Here, all of the stock of an established business, Alloyd Co., was owned by the seller-defendants.[44] After lengthy negotiations, the buyer, a sophisticated venture capital firm, entered into a stock purchase agreement for the acquisition of all of the Alloyd Co. stock from the company's former shareholders who were acting as sellers.[45] This private resale of stock,

---

38 *See generally* 9 LOSS & SELIGMAN, *supra* note 34, at 4212–16. "There is not much law on how this defense may be established." LOSS & SELIGMAN, *supra* note 7, at 989. The leading case interpreting the scope of the seller's reasonable care defense is *Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981), although Justice Powell's pointed dissent from the Court's denial of review is quite instructive in analyzing the standard imposed under section 12(2)'s affirmative defense of "reasonable" care. *See* John Nuveen & Co. v. Sanders, 450 U.S. 1005, 1009 (1981).

39 The scope of the seller's obligation under this affirmative defense depends in large part on *who* the seller is (control person vs. noncontrol person vs. securities industry professional) and the relationship of the parties and their bargained-for allocation of risk. *See generally* Maynard, *supra* note 34; Committee on Fed. Reg. of Sec., *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW. 1185 (1993).

40 Unlike Rule 10b-5 which requires the plaintiff to establish that defendant acted with scienter, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976), section 12(2) seems to be predicated on a negligence standard. *See* JENNINGS ET AL., *supra* note 7, at 882.

41 *See infra* notes 42–44 and accompanying text.

42 The facts and reasoning of *Gustafson* have been detailed at length elsewhere. *See supra* note 26 (listing numerous articles written about *Gustafson*).

43 *See supra* notes 16–22 and accompanying text.

44 *See* Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1064 (1995).

45 *See id.* at 1065.

more commonly known as a secondary distribution, was structured to qualify for an exemption from section 5 registration.[46] In addition, the stock purchase agreement set out a complex formula for the contract price. The parties' agreement called for a post-closing adjustment of the purchase price based on a year-end audit to be conducted in the ordinary course of preparing the business's year-end financials.[47] In particular, inventory levels were of concern to the parties; however, during their negotiations, they decided against an audit at the time of the closing on the stock purchase in favor of waiting for the usual year-end audit.[48] As a result, the parties agreed to a complex formula for the adjustment of the purchase price once the results of the year-end audit became known.[49]

When completed, the year-end audit showed that the buyer was entitled to an adjustment of the purchase price.[50] The seller stonewalled on paying the adjustment.[51] The buyer then filed suit in federal court, alleging, among other claims, a section 12(2) cause of action.[52] While litigation was pending, the seller-defendant finally decided to pay the requested amount of the price adjustment pursuant to the parties' agreement.[53] The buyer-plaintiff, however, refused to accept payment of the post-closing adjustment, deciding instead to proceed with the rescission remedy of section 12(2).[54] The buyer's claim under section 12(2) was based primarily on allegations of material misrepresentation contained in the parties' written contract, *i.e.*, their stock purchase agreement, including allegations that the seller-defendants made misleading statements regarding the company's financials, particularly as to the business's inventory levels.[55]

---

[46] For general background regarding the fairly narrow legal issue that was before the Supreme Court on the facts of the secondary distribution that was at issue in the *Gustafson* case, see Dennis J. Block & Jonathan M. Hoff, *Section 12(2): Private and Secondary Transactions*, N.Y. L.J., Dec. 15, 1994, at 5; Therese H. Maynard, *The Future of Securities Act Section 12(2)*, 45 ALA. L. REV. 817 (1994); Maynard, *supra* note 1; John F.X. Peloso & Stuart M. Sarnoff, *Section 12(2) and Secondary Transactions*, N.Y. L.J., Apr. 21, 1994, at 3.

[47] *See Gustafson*, 115 S. Ct. at 1065.

[48] *See id.*

[49] *See id.*

[50] *See id.*

[51] *See id.*

[52] *See id.*

[53] *See id.*

[54] *See id.*

[55] *See id.*

III. THE RESULT IN *GUSTAFSON* BASED ON METHODOLOGY OF SUPREME COURT PRECEDENT

On these facts, *neither* the buyer nor the seller appears to deserve sympathetic treatment. Indeed, several commentators have speculated that the Court may have been reacting to what amounts to bad facts[56]—simply proving the truth of that well-worn law school adage "Hard Facts Make Bad Law!" Although these "bad facts" may very well have influenced the Court, there is more to this story.

Accepting that this is not a sympathetic case, the crucial question becomes: In light of the Court's accepted methodology in this area and relying on settled precedent interpreting the language of the 1933 Act, how should the Supreme Court have ruled on these "bad facts"? This section describes how the Supreme Court should have resolved this case based on the Court's own teaching and established interpretations of the 1933 Act. In other words, if the desired outcome on these facts was to deny the buyer in *Gustafson* any recovery under section 12(2), the analysis that follows will demonstrate how that result could have been reached *without* distorting statutory language and *without* betraying the method of analysis that had formed the foundation of the High Court's securities law jurisprudence for at least the last two decades.

As the Supreme Court has been instructing securities lawyers for the last twenty years, the starting point of the analysis should be the language of section 12(2) itself. The statute requires the buyer-plaintiff to show that the seller-defendant made a materially misleading statement—"by *prospectus* or oral communication."[57] The next step would be to turn to the statute's broad definition of the term "prospectus," as found in section 2(10).[58] Indeed, established judicial and administrative precedent had interpreted this definition to include virtually *any* writing that offers a security for sale.[59] Based on this

---

[56] *See, e.g.*, Karmel, *supra* note 26; Edmund W. Kitch, Gustafson v. Alloyd Co.: *An Opinion That Did Not Write*, 1995 SUP. CT. REV. 99 (1996).

[57] 15 U.S.C. § 77*l*(a)(2) (Supp. 1996) (emphasis added).

[58] Under the definition contained in section 2(10) of the 1933 Act, a "prospectus" is "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77(b)(10) (1994).

[59] *See generally* 1 LOSS & SELIGMAN, *supra* note 34, at 463-64 (in particular, the cases cited in note 173 construing the definition very broadly); *id.* at 466-77 (describing administrative authority that reflects the breadth of the SEC's long-standing interpretation of the statute's definition of "prospectus"). Recently, the breadth of this well-settled interpretation of section 2(10) has come under increased scrutiny, prompting the SEC to

settled understanding of the 1933 Act, the stock purchase agreement at issue in *Gustafson* would fall within the statute's definition of "prospectus," as that term is used in section 12(2).[60] As to the next element, the buyer in *Gustafson* presumably would readily satisfy the statute's built-in privity requirement by showing that the buyer bought the Alloyd Co. stock from these seller-defendants. Lastly, the buyer would have to demonstrate that the sellers' misleading statements regarding inventory contained in the "prospectus"—that is, the stock purchase agreement—were *material*.[61]

Assuming the materiality element was met, the burden of proof would then shift to the seller-defendants to demonstrate under section 12(2)'s affirmative defense that they exercised reasonable care in connection with any statements made regarding the business's inventory levels. The seller-defendants would be required to show the candor and truthfulness of statements made to this financially sophisticated buyer as to what appears to be a heavily negotiated aspect of the parties' agreement. On these facts, the seller-defendants very likely would prevail on the reasonable care defense by showing that the parties' negotiations resulted in an agreed-upon allocation of economic risk as to the

---

issue a concept release in June 1995 suggesting that it will consider administrative efforts to scale back its interpretation of this term in light of recent developments in the securities markets. *See* Securities Act Release No. 7188 (June 27, 1995), *reprinted in* FED. SEC. L. REP. (CCH) ¶ 85,639 (1993); Linda Quinn, Director of Division of Corporation Finance, SEC, Reforming the Securities Act of 1933: A Conceptual Framework, Address to the Committee of Federal Regulation of Securities of the American Bar Association Section of Business Law (Nov. 11, 1995), *in* 10 INSIGHTS 25 (Jan. 1996).

[60] Indeed, that was how the Seventh Circuit disposed of the *Gustafson* case. *See* Pacific Dunlop Holdings Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993). This same line of reasoning was emphasized by the dissenting opinions in *Gustafson*. *Gustafson*, 115 S. Ct. at 1074, 1079 (Thomas & Ginsburg, JJ., dissenting).

[61] Under section 12(2), plaintiff's burden of proof is to establish both the existence *and* the materiality of the sellers' misleading statements. *See supra* notes 27–36 and accompanying text (describing elements of section 12(2) cause of action). This proof, however, may be undermined by the sellers' efforts to establish their exercise of reasonable care. For example, on the facts of *Gustafson*, the seller may be able to successfully claim that the parties bargained for an allocation of the economic risk associated with the estimation of the business's inventory levels as set forth in the parties' stock purchase agreement. This bargained-for arrangement was then reflected in their complex provisions for adjusting the purchase price depending on the results of the year-end audit. In that case, the sellers' ability to maintain the affirmative defense of reasonable care undercuts both the existence *and* the materiality of plaintiff's allegations of misleading statements made by the sellers about the business's inventory. *See supra* notes 37–41 and accompanying discussion (describing how the sellers' affirmative defense may reflect parties' bargained-for allocation of economic risks of their transaction).

business's inventory levels.[62]

In sum, based on established precedent, the buyer-plaintiff probably could plead facts as to the elements of a section 12(2) cause of action sufficient to withstand a demurrer. However, equally probable is that the seller-defendants could demonstrate their exercise of reasonable care, thereby ultimately denying the buyer any relief under this express remedy.[63] Therefore, based on its own teachings, the Supreme Court should have ruled in *Gustafson* that the buyer adequately pled a section 12(2) cause of action, but then the Court should have remanded the case to the lower court with very stern instructions regarding the availability of the seller's reasonable care defense.[64] Had the Court ruled this way, the *Gustafson* decision would not be controversial. Instead it would be rather a non-event, other than the incremental value it would have contributed to the common law evolution of the federal securities laws.

IV. THE COURT'S METHODOLOGY IN *GUSTAFSON*

In a close decision,[65] the Supreme Court in *Gustafson* rejected, over strong

---

[62] The seller's ability to prevail on this affirmative defense depends, of course, on the absence of any misleading statements that deceive the buyer and thereby undercut the assumptions that form the basis for the formula for the purchase price adjustment included in the parties' stock purchase agreement.

[63] Of course, the seller would still have to absorb the transaction costs associated with this litigation. Although these costs are always a threat and no set of legal rules can ever completely immunize against *any* possibility of a lawsuit, good lawyering can minimize these costs. As this Essay demonstrates, however, the methodology of *Gustafson* undermines the possibility for good lawyering in the future because lawyers cannot responsibly counsel their clients on the application of the rule of law amidst the uncertainty created by the Court's unexplained shift in methodology in *Gustafson.*

[64] Both sides contributed to the hard facts of the *Gustafson* dispute: The sellers were at fault for not promptly paying up the post-closing adjustment—forcing the matter into litigation. The buyer was at fault for refusing to accept the seller's payment of the post-closing adjustment—in contravention of the parties' bargained-for allocation of risk. Instead, the buyer decided to sue to set aside the transaction and recover the entire purchase price. This turn of events is all the more disturbing when it appears, from the limited factual record developed at the pleading stage in *Gustafson,* that the parties negotiated for a particular outcome *if* inventory levels actually turned out different from the parties' assumptions, by calling for a modification of the purchase price to reflect the actual inventory levels as determined by the year-end audit. *See* Kitch, *supra* note 56, at 102.

[65] *See* Joan Biskupic, *Court Limits Stock Fraud Law*, WASH. POST, Mar. 1, 1995, at C2.

> [T]here are signs in this opinion that Kennedy and his side may have won the majority

dissenting opinions, what could have been a straightforward application of the statute's language. Instead, the Court held that this buyer-plaintiff had *no* cause of action whatsoever under section 12(2).[66] In light of the hard facts of this case, the Court's decision to deny this buyer any possibility of recovery is not surprising. What is astonishing is the *reasoning* used by the Court to conclude that there is no section 12(2) cause of action whatsoever available to this buyer-plaintiff. The Court's reasoning in *Gustafson* betrays its own jurisprudence by contradicting its methodology for interpreting the federal securities laws.[67]

In an abrupt departure from its own teachings, the Supreme Court did not start with a consideration of the definition of "prospectus" found in section 2(10). Instead, in a most astonishing move, the Court leaped over to section 10 of the 1933 Act,[68] which describes the contents of the disclosure document to be given to buyers in situations involving *registered* public offerings.[69] Before *Gustafson*, students of federal securities law—that is, scholars, judges, practicing lawyers, and the SEC—thought that section 10 was implicated *only* in situations where the seller decided to *register* the proposed sale of securities.[70]

By focusing its analysis on section 10, the Court's *method* of analysis came as a complete surprise to students of the federal securities laws.[71] In ignoring

---

> only at the last minute. The language of Kennedy's opinion refers so extensively to dissenting opinions by Thomas and Ginsburg that it suggests that Kennedy originally was writing a dissent, referring to what was supposed to be the majority.

Id.

66 *See* Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1067 (1995).

67 Indeed, Justice Thomas objected to the majority opinion on these grounds. *See id.* at 1074 (Thomas, J., dissenting). This Essay was written to emphasize that the decision in *Gustafson* reflects a *shift* in the Court's methodology. Although the Court does not explain the reasons for this shift, nonetheless the Court's betrayal of its established framework for analyzing issues under the federal securities laws carries important implications for the legal profession, as will be described in this section of the Essay. The purpose of this Essay, therefore, is not to discuss what theory of statutory interpretation the Court should use to decide cases such as *Gustafson*, nor does the Essay intend either to attack or defend the plain meaning approach that has generally characterized the Court's opinions in this area. As to possible theories of statutory interpretation, see *infra* note 92 and the authorities collected therein.

68 *Gustafson*, 115 S. Ct. at 1069.

69 *See* 15 U.S.C. § 17j (1994).

70 *See, e.g.*, LOSS & SELIGMAN, *supra* note 7, at 86–96; Karmel, *supra* note 26.

71 *See, e.g.*, Bloomenthal, *supra* note 26; Fiflis, *supra* note 1. "Even Professor Weiss, the leading academic proponent of the result reached by the majority, has remarked that Justice Kennedy's reliance on section 10 is 'mystifying indeed.'" Bainbridge, *supra* note 26

section 2(10) and turning instead to section 10, the Court overlooked a well-established body of precedent that treated writings such as the one at issue in *Gustafson* as a "prospectus" within the meaning of section 2(10)'s definition.[72] Likewise, the Court overlooked a well-established body of precedent that relied on the section 2(10) definition of "prospectus" for purposes of defining this term as it is used in section 12(2).[73] In sum, by failing to start its analysis with the section 2(10) definition of "prospectus," the Court turned its back on its own methodology.

Moreover, the Court's reasoning and distortions of statutory language in *Gustafson* substantially undermine settled understandings of various other aspects of the 1933 Act.[74] The Court's shift in methodology creates enormous uncertainty by upsetting settled interpretations of various provisions of the federal securities laws. Indeed, the *Gustafson* opinion is virtually an invitation to securities lawyers to mount challenges to established interpretations of other provisions of the 1933 Act.[75]

(citing Letter from Elliott Weiss to Stephen M. Bainbridge (Apr. 4, 1995) (on file with *The Business Lawyer*, University of Maryland School of Law)).

72 *See supra* notes 32-36 and accompanying text.

73 Indeed, this flaw in the Court's reasoning was pointed out by the two dissenting opinions in *Gustafson. Gustafson*, 115 S. Ct. at 1074, 1079 (Thomas & Ginsburg, J.J., dissenting). The purpose of this brief description of the Court's reasoning in *Gustafson* is not to set forth at length criticisms of the Court's analysis of the scope of section 12(2). For detailed commentary discussing the Court's reasoning, see authorities collected *supra* note 26. Instead, this brief summary of *Gustafson*'s reasoning is offered to emphasize the shift in methodology used by the Court in *Gustafson* in order to set the stage for examining the implications of the Court's analytical approach in *Gustafson.*

74 This abrupt departure from accepted understanding of sections 10 and 2(10) has not gone unnoticed nor has its potential to undermine other established doctrines under the federal securities laws. *See, e.g.*, *Gustafson*, 115 S. Ct. at 1078–79 (Thomas, J., dissenting); Fiflis, *supra* note 1.

75 The Court's reasoning is having a disquieting effect as securities lawyers struggle to figure out the implications of the Court's strained interpretation of the statute's language. *See, e.g.*, Robert B. Robbins, *Due Diligence in Private Placement Offerings*, 28 REV. SEC. & COMMODITIES REG. 109 (June 14, 1995) ("If *Gustafson* is to be taken at its word (and there are many who believe that it cannot be), section 12(2) cannot be a source of liability to private parties for misstatements in offers or sales other than in a registered public offering."); Richard Foster, *Due Diligence: An Accident Waiting to Happen?*, 15 INT'L FIN. L. REV. 23 (Mar. 1996). The Court's flawed reasoning and distortions of statutory language has provided the cannon fodder encouraging lawyers to mount a frontal assault on established understandings of various other aspects of the 1933 Act as well. Some of these implications have been identified by the commentators. *See, e.g.*, Bloomenthal, *supra* note 26; Harold Bloomenthal, *Supreme Court Says Sec. 12(2) Liability Does Not Extend to Private Offerings or Secondary Trading*, 17 SEC. & FED. CORP. L. REP. 38 (CBC) (May

One example of such a challenge relates to issuers' exempt financings known as private placements. As part of its private placement, the issuer generally prepares a disclosure document known as a placement memorandum (PPM) that is then made available to prospective buyers in these capital formation transactions. The PPM generally is exempt from registration under the 1933 Act.[76] Although the PPM has traditionally and consistently been thought of as a "prospectus," [77] several lower courts now feel constrained to conclude that the PPM, distributed as part of an issuer's exempt private placement, is not a "prospectus" as that term is interpreted in *Gustafson*.[78] This emerging line of cases is but one example of the disquieting effect that the Court's reasoning is having on the *practice* of securities law: It is encouraging lawyers to challenge established precedent (in this example, the well-established precedent treating the PPM as a "prospectus" for purposes of the section 12(2) remedy).

1995); Fiflis, *supra* note 1. Certain well-established precedents under the federal securities laws have already been challenged in the courts. *See, e.g.*, Stack v. Lobo, 903 F. Supp. 1361 (N.D. Cal. 1995); Komanoff v. Mabon, Nugent & Co., 884 F. Supp. 848 (S.D.N.Y. 1995); *In re* Regal Communications Corp. Sec. Litig., No. 94-179, 1995 WL 550454 (E.D. Pa. Sept. 14, 1995); *In re* U.S.A. Classic Sec. Litig., No. 93 Civ-6667 (JSM), 1995 WL 363841 (S.D.N.Y. June 19, 1995); *In re* Valence Tech. Sec. Litig., No. C-94-1542-SC, 1995 WL 274343 (N.D. Cal. May 8, 1995); Pollack v. Laidlaw Holdings, Inc., No. 90-Civ.-5788 (DLC), 1995 WL 261518 (S.D.N.Y. May 3, 1995); Endo v. Albertine, No. 88-C-1815, 1995 WL 170030 (N.D. Ill. Apr. 7, 1995).

[76] Private placement financings using a PPM are frequently conducted pursuant to the exemption found in section 4(2). 15 U.S.C. § 77d(2) (1994). In addition, a disclosure document known as a PPM may also be distributed in connection with issuers' financings made pursuant to the hybrid exemption of Regulation D. *See* 17 C.F.R. §§ 230.504 to .506 (1996). For further discussion of the impact of *Gustafson* on Regulation D financings, see Bloomenthal, *supra* note 75.

[77] Indeed, shortly before the Court's decision in *Gustafson*, Professor Coffee, a well-known authority on the federal securities laws, observed that "it is clear beyond argument that Section 12(2) applies to private placements." John C. Coffee, *A Statutory & Caselaw Primer on Due Diligence Under the Federal Securities Laws*, *in* CONDUCTING DUE DILIGENCE 1995, at 11 (PLI Corp. L. & Prac. Course Handbook Series No. 886, 1995); *see also* Karmel, *supra* note 26, at 33 ("It is axiomatic that although privately placed securities are exempt from the registration provisions of the Securities Act, they are not exempt from the antifraud provisions.").

[78] *See* Whirlpool Fin. Corp. v. GN Holdings, Inc., 67 F.3d 605, 609 (7th Cir. 1995); ESI Montgomery County, Inc. v. Montenay Int'l Corp., 899 F. Supp 1061, 1064-65 (S.D.N.Y. 1995); Glamorgan Coal Corp. v. Ratner's Group PLC, No. 93 Civ. 7581 (RO), 1995 WL 406167, at *2 (S.D.N.Y. July 10, 1995). For a detailed analysis of these decisions, see Maynard, *supra* note 2.

A. *The Impact of the Court's Methodology on the Securities Lawyer*

Even more disturbing, however, is that the Supreme Court's methodology in *Gustafson*—by casting doubt on established interpretations of the federal securities laws—carries profound implications for the legal profession as well. Under generally accepted rules of professional conduct and rules of procedure, lawyers are required to have some reasonable basis—in law and in fact—to maintain legal claims.[79] The lawyer therefore must be able to show that the position taken is justified on the law and on the facts.[80] The Court's methodology in *Gustafson* expands the boundaries for making that kind of judgment. In other words, the reasoning in *Gustafson* now affords lawyers a basis for taking a position that *might possibly* persuade a court of the desired result. By relying on *Gustafson*'s flawed reasoning to expand the boundaries, lawyers have been relieved in substantial measure of their professional obligation to exercise *judgment*. Thus, *Gustafson* can be seen as relieving lawyers of the burden of applying established precedent in order to serve as responsible problem solvers.

Up to now, securities lawyers have been trained to begin their analysis with the language of the statutes, as augmented by a rich body of administrative and judicial interpretive authority. As a result, securities lawyers have shared, at some level, a common understanding of how to think about the federal securities laws in order to apply the mandates of federal law to a particular securities law matter. Although there may be reasonable disagreements as to how the law applies to a particular set of facts, there has been a shared understanding of the *method* of analysis to be used to resolve legitimate differences in interpretations of the relevant portions of the federal securities laws. In resolving the dispute at issue in *Gustafson*, the Court distorted the language of the statute, thereby disrupting established precedent that had previously formed the framework for the legal analysis of securities law issues. In so doing, the Court gave permission to securities lawyers to engage in the same kind of distortion. Thus, the Court's method of analysis in *Gustafson*

---

[79] *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.1 (1993); FED. R. CIV. P. 11. The Court's shift in methodology in *Gustafson* may present implications for the application of Rule 11 sanctions. For a more detailed discussion of the scope of Rule 11, see generally GEORGENE M. VAIRO, RULE 11 SANCTIONS: CASE LAW PERSPECTIVES AND PREVENTIVE MEASURES (2d ed. 1992 & Supp. 1995); William W. Schwarzer, *Rule 11: Entering a New Era*, 28 LOY. L.A. L. REV. 7 (1994); Georgene M. Vairo, *The New Rule 11: Past as Prologue?*, 28 LOY. L.A. L. REV. 39 (1994).

[80] *See, e.g.*, Wesley A. Cann, Jr., *Frivolous Lawsuits—The Lawyer's Duty to Say "No,"* 52 U. COLO. L. REV. 367 (1981).

contributes to the further erosion of the rule of law.

B. *Why Did the Supreme Court Use the Reasoning It Did in* Gustafson?

In light of the disquieting impact of *Gustafson*, the question naturally arises: Why did the Court in *Gustafson* deliberately choose to turn its back on its own accepted methodology for analyzing securities law issues? Several explanations have been offered.

One possible explanation is to regard *Gustafson* as just another case where the Supreme Court did not understand the nature of the issue presented by the case and further did not understand how to apply the relevant securities law provisions to the problem before it. This explanation, however, rings hollow when one considers that the dissent in *Gustafson* understood the relevant precedent and, indeed, followed the established understanding of the use and scope of the section 2 definitions within the overall structure of the 1933 Act.[81]

Alternatively, *Gustafson* may be seen as the Court's own effort at securities litigation reform. The Court's result is at least consistent with this perspective. In a further effort to limit the availability of *federal* remedies for securities fraud, the Court in *Gustafson* may have decided to adopt a narrow interpretation of the express remedy of section 12(2).[82] However, this is clearly

---

[81] Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1074, 1079 (Thomas & Ginsburg, J.J., dissenting).

[82] *See* James H. Cheek III, *Emerging Issues and Significant Developments in Securities Law*, *in* NUTS AND BOLTS OF SECURITIES LAW, at 573 (PLI Corp. L. & Prac. Course Handbook Series No. 889, 1995) ("The [*Gustafson*] decision is a further signal of the inclination of the Supreme Court to constrain the growth of litigation in the securities area."); Phillip D. Parker, *Overview of Securities Litigation Reform*, *in* BROKER-DEALER REGULATION, at 141 (ALI-ABA Course of Study Series No. C977, 1995). Ironically enough, the Court's decision in *Gustafson* came at a time when Congress was actively pursuing its own proposals for reform of securities litigation under the federal securities laws that culminated in enactment of the Private Securities Litigation Reform Act. *See supra* note 4; John C. Coffee, Jr., *SEC Deregulation: Sense and Nonsense*, N.Y. L.J., Sept. 28, 1995, at 5; Diana B. Henriques, *Efforts to Harness SEC Worry Agency Critics Too*, N.Y. TIMES, Oct. 23, 1995, at 1.

Another way of looking at *Gustafson* is to view it an as effort by the Supreme Court to effect a re-allocation of cases between state and federal courts. This bias has been reflected in earlier Court decisions, such as *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), with "[t]he practical effect of the decision . . . to focus attention on state law as a possible regulator . . . ." HAMILTON, CORPORATIONS 943 (5th ed. 1994). It is important to note, however, that the Court decided *Santa Fe Industries* using a method of analysis that is now quite familiar, emphasizing the plain language of the statute and eschewing public policy a results-oriented explanation, since this result is obtained at the expense of doctrinal consistency and is reached only by betraying the Court's own teachings. This explanation would suggest that the Court is willing to pursue reform at any cost!

A related argument is that the Court may have been persuaded to take a restrictive perspective because of a fear that the section 12(2) remedy would balloon out of proportion, as Rule 10b-5 did in its early years.[83] However, to the extent the Court's reasoning is predicated on this fear, it is entirely misplaced. Relief under section 12(2) is based on satisfying the statutory prerequisites to this express cause of action, and the built-in privity requirement of section 12(2) substantially limits the availability of this express cause of action. Moreover, the seller can avoid liability on the merits by meeting the statute's affirmative defense of reasonable care.[84] These statutory prerequisites imposed by Congress establish important limitations on the availability of this remedy, unlike the *implied* cause of action available under Rule 10b-5 where the federal courts have been left the primary responsibility for defining the elements of this *implied* remedy.[85]

---

considerations as the basis for the result reached in that case. The Court's reasoning in *Santa Fe Industries* therefore stands in marked contrast to the unexplained shift in methodology that is reflected in the Court's decision in *Gustafson.*

In a manner consistent with the result reached in *Santa Fe Industries*, the tenor of the *Gustafson* opinion therefore may be seen as reflecting a strong sense that these "private" transactions—resales of closely held businesses—do not belong in federal court. The difficulty with this line of reasoning, however, is that it overlooks the clear jurisdictional premises of the 1933 Act as interpreted by well-settled precedent. Congress imposed the statute's regulatory framework on "sales" of "securities" using the facilities of "interstate commerce." Indeed, it was this very understanding of the plain meaning of the statute's language that led the Supreme Court in *Landreth* to reject the sale of business doctrine. *See supra* notes 16–22 and accompanying text.

[83] *See supra* notes 5–15 and accompanying text.

[84] Section 12(2)'s reasonable care defense does *not* eliminate altogether any possibility of a lawsuit. However, any effort at securities litigation reform must grapple with the basic question of whether "reform" is to *deny* the defrauded securities buyer a cause of action *altogether*, or alternatively whether "reform" measures are to concentrate on the litigation *process* itself, as by raising pleading requirements, curbing discovery abuses, modifying the procedures for class action suits, etc. The *Gustafson* decision (to the extent that it can be viewed as a crude effort at litigation reform) opts to eliminate a possible cause of action by narrowing the availability of the express remedy of section 12(2).

[85] The Court's discomfort in assuming this responsibility has been well documented elsewhere. *See supra* notes 11–13 and accompanying text. However, the Court is not confronted with that kind of responsibility when applying the terms of the *express* remedy of section 12(2). It would have been interesting to allow section 12(2) the chance to develop in

Another explanation for the Court's reasoning in *Gustafson* is also related to the development of the Rule 10b-5 implied remedy. The Supreme Court could have taken the view that the private remedy of section 12(2) has been rendered obsolete in light of the intervening judicial development of the implied remedy of Rule 10b-5. In other words, the Court could have decided *Gustafson* the way it did because it views section 12(2) as presenting the potential to upset the delicate balance the Court has struggled to achieve in its Rule 10b-5 jurisprudence. For the past twenty years or so, the Supreme Court has struggled mightily to impose limitations on the implied cause of action available under Rule 10b-5.[86] The Court may very well have worried that these limitations would be threatened if section 12(2) relief was made broadly available.[87] Seen from this perspective, *Gustafson* may be viewed as the Court's effort to reconcile the remedies of Rule 10b-5 and section 12(2) so as to protect the integrity of the Court's own jurisprudence interpreting the implied Rule 10b-5 remedy.[88]

There are, however, several difficulties with this explanation for the Court's methodology in *Gustafson*. First, this explanation overlooks the fact that the Court is disregarding the plain meaning of the statute's *express* remedy in favor of protecting an *implied* remedy put in place under the later-adopted 1934 Act. If the Court is willing to distort the clear language of the 1933 Act in order to preserve its Rule 10b-5 jurisprudence, what are the limitations on the

---

order to determine the efficacy of these legislatively imposed limitations.

[86] *See supra* notes 5–13 and accompanying text.

[87] Professor Steven Thel has made a variant of this argument. In his Essay, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 FORDHAM L. REV. 1183 (1995) (which was published while the *Gustafson* appeal was pending before the Supreme Court), Professor Thel asserted that the Court

> should follow its own judgment of whether it is wise to limit the remedies available in securities fraud litigation, even if that judgment conflicts with the statute. . . . The point of this Essay is that the language, structure and history of the Securities Act ought not to determine this debate—the Court is not bound by the statute . . . . [T]he Court is likely to consider the [Rule] 10b-5 issue, although it may not acknowledge doing so. Despite the problem of apparent overreaching, if the Court believes that denying some classes of buyers the remedy of section 12(2) will improve the law, then the Court should consider doing so even though section 12(2) indicates that it is available to all buyers.

Id. at 1184, 1187, 1192 (footnote omitted).

[88] Therefore, the Supreme Court does not want to open the door (even a crack) to the possibility of undercutting its hard-won efforts to contain the scope of relief available under federal law for securities fraud by making relief under the negligence standard of section 12(2) broadly available.

scope of this authority? Moreover, the Court apparently is now willing to limit the availability of the section 12(2) express remedy—in contravention of the plain meaning of the statute's language—in order to give predominance to the *implied* remedy of Rule 10b-5. The High Court, however, never gave any indication as to why the *implied* remedy of the *later* adopted statute should serve as a basis for limiting the *express* remedy provided by the plain meaning of the statute's language, especially when this result is reached only by using a method of analysis that contradicts the Court's own teachings in the area. Lastly, this effort to protect the hard-won gains in the Court's Rule 10b-5 jurisprudence can be viewed as a substantial overreaction, since the section 12(2) remedy carries specific statutory prerequisites that already limit the scope of relief available—most notably, the privity requirement and the seller's reasonable care defense. Thus, any fear by the Court that its Rule 10b-5 jurisprudence will be displaced is not realistic since the procedural limitations of section 12(2) should operate to prevent this remedy from ballooning the way Rule 10b-5 did in its infancy.[89]

Another explanation for the Court's reasoning focuses on the wisdom of the *result* reached in *Gustafson*. Several commentators argued at length for the result reached in this case.[90] However, the argument in support of this result was predicated in large part on the legislative history of the 1933 Act. These commentators essentially argued that the section 12(2) cause of action was

---

[89] Or, at least we ought to give section 12(2) a chance to develop—to see if the statute's prerequisites operate effectively to limit the scope of relief available. This opportunity would be a chance that section 12(2) really did not have—at least not until quite recently—in light of the expansive interpretation given early on to the Rule 10b-5 implied remedy. *See supra* notes 4–15 and accompanying text. Moreover, allowing section 12(2) a chance to grow and evolve could yield valuable lessons that would be important both from a legislative perspective in crafting, as well as the judiciary's perspective in interpreting, securities fraud remedies in the future. Indeed, *Gustafson* reflects a most ironic twist in the Court's reasoning. Starting back in the 1970s, the High Court pointed to, and emphasized, these very same procedural limitations on the express remedies set out in the 1933 and 1934 Acts—including the procedural limitations on section 12(2)—to support imposing a scienter requirement as well as other restrictions on the implied remedy of Rule 10b-5. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 210 (1976) (Without a scienter requirement, the Rule 10b-5 implied remedy "would allow causes of action covered by §11, §12(2) [of the 1933 Act] and §15 [of the 1933 Act] to be brought instead under §10(b) [and its Rule 10b-5 under the 1934 Act] and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.").

[90] This view was most forcefully presented by Professor Elliott J. Weiss in his article, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1 (1992).

limited to a narrow band of activity known as distribution transactions (generally referred to as public offerings) and that Congress did not intend to extend the section 12(2) remedy to post-distribution activity (generally referred to as trading transactions in the secondary markets).[91] Thus, this view is premised in substantial measure on the legislative history of two great pieces of legislation (the 1933 and 1934 Acts), which generally indicates that the 1933 Act was concerned primarily with distribution transactions and regulating the process of capital formation, whereas Congress intended that the 1934 Act address primarily secondary market trading.[92]

However, in reaching its result in *Gustafson*, the Supreme Court declined to rely primarily on legislative history in favor of an approach that the Court maintains is based on the statute's language.[93] In other words, the Supreme Court could have limited the scope of section 12(2)—and denied the buyer-plaintiff in *Gustafson* any relief—by relying primarily on its interpretation of legislative history, but the Court's thrust was elsewhere. Instead, the Supreme Court preferred to bastardize the statute's language to reach the result it apparently so desperately wanted, all the while claiming that it was relying on

---

[91] *See, e.g., id.* at 13-14.

[92] This argument is a fairly powerful one that is difficult to meet. However, this argument draws its force from its reliance on legislative history, thereby revisiting the ongoing controversy over statutory interpretation, including the role of legislative history in the courts' interpretation of statutes. *See, e.g.*, Melvin A. Eisenberg, *Strict Textualism*, 29 LOY. L.A. L. REV. 13 (1995); William N. Eskridge, Jr., *Gadamer/Statutory Interpretation*, 90 COLUM. L. REV. 609 (1990); William N. Eskridge, Jr., *Spinning Legislative Supremacy*, 78 GEO. L.J. 319 (1989); William N. Eskridge, Jr. & Phillip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321 (1990); Phillip P. Frickey, *From the Big Sleep to the Big Heat: The Revival of Theory in Statutory Interpretation*, 77 MINN. L. REV. 241 (1992); Joseph A. Grundfest, *We Must Never Forget That It Is an Inkblot We Are Expounding: Section 10(b) As a Rorschach Test*, 29 LOY. L.A. L. REV. 41 (1995); McNollgast, *Positive Canons: The Role of Legislative Bargains in Statutory Interpretation*, 80 GEO. L.J. 705 (1992); Jerry L. Mishaw, *Textualism, Constitutionalism, and the Interpretation of Federal Statutes*, 32 WM. & MARY L. REV. 827 (1991); Margaret V. Sachs, *Are Local Governments Liable Under Rule 10b-5? Textualism and Its Limits*, 70 WASH. U. L.Q. 19 (1992); W. David Slawson, *Legislative History and the Need to Bring Statutory Interpretation Under the Rule of Law*, 44 STAN. L. REV. 383 (1992); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405 (1989); Nicholas S. Zeppos, *Judicial Candor and Statutory Interpretation*, 78 GEO. L.J. 353 (1989); Nicholas S. Zeppos, *Legislative History and the Interpretation of Statutes: Toward a Fact-Finding Model of Statutory Interpretation*, 76 VA. L. REV. 1295 (1990); Heidi A. Sorensen, Note, *A New Gay Rights Agenda? Dynamic Statutory Interpretation and Sexual Orientation Discrimination*, 81 GEO. L.J. 2105 (1993).

[93] *See* Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1066-69, 1071 (1995).

the plain meaning of the statute's language. So, *Gustafson* teaches the bench and bar that if the language of the statute does not seem to get to where one wants to go, the Supreme Court is willing to distort the statute's language to get the desired result—rather than rely on legislative history.

V. CONCLUSION

None of the possible explanations for the Supreme Court's shift in methodology in *Gustafson* justify the Court's distorted use of the statute's language in its decision. Moreover, all of these possible explanations share a fundamental weakness by casually overlooking the most distressing implication of *Gustafson*'s methodology: None of the explanations take into account the disquieting effect that the Court's opinion has had on the practice of securities law and on the ability of securities lawyers to render professional advice in a responsible fashion to their clients. By distorting the statute's language to reach the desired result, the Court's opinion shakes the very foundation of some of the most well-established doctrines in the area of federal securities law.

This uncertain environment—created by the Court's flawed analysis in *Gustafson*—is most unfortunate because the capital markets depend on the predictability and certainty of the legal rules. Parties can rely on their lawyers to contract around the settled understanding of the default rules established under the federal securities laws, but the lawyers' efforts depend on a clear understanding of those relevant rules. Thus, the rule of law is crucial in this area of practice so that securities lawyers can properly advise their clients on how to structure their transactions in order to allocate the economic risks of doing business by appropriate allocation of due diligence burdens. The ability of securities lawyers to be competent and responsible problem solvers depends in large part on being able to rely on the Court's heretofore established framework for analyzing issues and resolving differences in applying the various provisions of the federal securities laws. This framework has been substantially undermined by the Supreme Court's methodology in *Gustafson*.

In short, the Supreme Court in *Gustafson* ignored another time-honored adage: If it ain't broke, don't fix it. Instead, the Court decided to fix the scope of section 12(2)'s express remedy without explaining the need to do so—and did so by distorting the language of the statute, thereby undermining established securities law precedent. Left in the wake of *Gustafson* are very troubling implications for the ability of securities lawyers to act as responsible problem solvers.